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Central Bank Reform and the Politics of Blame Avoidance in the UK

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Abstract

Following the financial crisis, the UK central bank gained important new prudential powers for upholding financial stability. Yet the reforms diverged significantly from the government's original plans and arguably produced a suboptimal institutional design. Drawing on theories of blame avoidance, we argue that the changes were motivated primarily by the need to manage reputational risk. Prior to the 2010 election, the two main parties tried to deflect blame for the crisis by putting forward competing proposals for agency reconfiguration. In response, the Bank of England pursued a strategy of agency subversion aimed at reshaping the reforms to minimise future reputational damage. This involved pushing for 'hard' delegation to maximise control of new macroprudential powers, while using 'fuzzy' delegation to shift microprudential supervision down to subordinate agencies. The article sheds new light on the drivers of post-crisis reform and the importance and limits of delegation as a strategy of blame avoidance.

Keywords Central banks, blame avoidance, macroprudential regulation, bank supervision.

Introduction

Since the financial crisis, far-reaching institutional reforms have been introduced in the UK aimed at strengthening the stability of the banking system. This has led to the central bank being granted important new macro- and micro-prudential powers to uphold financial stability. Given the scale and depth of the banking crisis in the UK, there was broad agreement across the political spectrum that fundamental reform was needed. Yet the reforms proved surprisingly contentious, diverging significantly from the government's original plans and arguably producing a suboptimal institutional design. How can we explain this?

The crisis has generated important new research on national central banks (Klompa and de Haana 2009; Masciandaro 2009, 2012; Cukierman 2013; McPhilemy 2013; Reichlin and Baldwin 2013; Bell and Hindmoor 2015, 2016; Goodhart 2015; Howarth and Quaglia 2016). Functionalist accounts focus on how and why delegated powers have been reconfigured by the financial crisis. Critics have argued that the narrow monetary policy mandate granted to central banks prior to the crisis contributed to the accumulation of unsustainable financial risk (for an overview, see Galati and Moessner 2011). In response, new macroprudential regulatory tools and enhanced microprudential supervisory responsibilities have therefore been delegated by governments to independent central banks (Eijffinger and Masciandaro 2011).

Ideational accounts of post-crisis reform draw on processes of policy learning and diffusion. In an important contribution, Baker (2013a, 2013b, 2015) highlights the role of 'norm entrepreneurs' in promoting a macroprudential ideational shift since the financial crisis. From this perspective, macroprudential regulation originated amongst transnational networks of financial technocrats and regulators, producing a common interpretive frame for understanding the crisis and advancing institutional blueprints for regulatory reform at the national level (see also McPhilemy 2016). These explanations are valuable because they help to explain cross-national similarities in institutional reform. Yet they work best when applied to third-order change; that is, the ideas, assumptions and discourse that informs or sets the overarching objectives of policy in a given area (Hall 1993). But they are arguably less useful at explaining second- or first-order change; the institutional arrangements and instruments used to achieve those objectives. In particular, ideational perspectives on their own are unable to account for persistent or increasing national differences in central bank reform since the crisis.

With respect to macroprudential regulation, the terms on which new countercyclical policy tools have been delegated, and the extent to which they are subject to political control, differs markedly. A clear divide exists between those countries where macroprudential oversight committees are chaired by a member of the government (as in the US) or by the head of the central bank (the Eurozone) (Goodhart 2015). Similarly, there is no consensus regarding the precise location of microprudential supervision. Although many large economies have moved towards the 'twin peaks' regime which locates prudential supervision and conduct regulation in separate authorities, the single authority model combining both functions remains dominant across much of Europe (ECB 2010).[1] Important differences also persist over whether supervision of large financial institutions is fully integrated into the central bank or is housed in a separate subsidiary or independent agency. This continued variation points to the relevance of national-level variables in mediating shared pressures for reform.

This article seeks to complement existing functional and ideational perspectives on central bank reform (Goodhart 2015). Using the UK as a case study, our central claim is that the post-crisis reforms are the outcome of a process of political and bureaucratic contestation. Drawing on theories of blame avoidance, we argue that the changes were shaped in large part by a concern for managing reputational risk. This comes from two main observations. First, in the run up to the 2010 general election, the two main parties tried to deflect blame for the crisis by pursuing agency reconfiguration. In particular, the Conservative opposition sought to attribute blame to the incumbent Labour government by pledging to scrap the Financial Services Authority and transfer new prudential powers to the Bank of England. Second, following the formation of a new Coalition Government in May 2010, the Bank pursued a strategy of agency subversion aimed at reshaping the changes to minimise future reputational damage. It did so in two ways. Where blame for future policy failure could potentially be deflected, it used fuzzy delegation to shift new policy responsibilities down to subordinate agencies (e.g. microprudential supervision). By contrast, where blame could not ultimately be avoided, it fought for hard delegation to maximise control over new regulatory powers (e.g. macroprudential regulation). We argue that this resulted in an institutional design which not only diverged significantly from the government's original plans, but which was also arguably sub-optimal. Our research is based on twenty-six anonymous interviews conducted between 2013 and 2015 with senior officials from the Bank of England, HM Treasury, 10 Downing Street, the Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA), as well as financial practitioners in the City of London, who were directly involved in the reform process.

The following section provides an overview of existing functionalist explanations of central bank powers, before outlining the added value of our blame avoidance approach. The next section analyses how elected officials sought to deflect blame by putting forward competing reform proposals. The main section then examines how the Bank of England responded in an effort to protect its reputation. The conclusion reflects on how the article sheds new light on the drivers of post-crisis reform and the importance and limits of delegation as a strategy blame avoidance.

Functionalist explanations of central bank reform

Functionalist accounts draw on principal-agent analysis to explain why governments delegate power to autonomous regulatory agencies, like central banks (McCubbins and Schwartz, 1984; Miller and Whitford, 2016). First, agencies provide credible commitments to desirable policy outcomes. By removing direct control from elected politicians, there is less scope to manipulate policy instruments for electoral reasons. Second, delegation can enhance the efficiency of decision-making by facilitating the development of technical knowledge and expertise in complex regulatory fields. Finally, agencies can be used for blame shifting, allowing policy makers to delegate responsibility for unpopular or contested decisions. Principal-agent analysis also tells us that delegation comes at a price in the form of agency loss. This occurs when the preferences of the principal and agent diverge, either because the agent pursues its own preferences (agency 'slippage') or because institutional incentives cause the agency to behave contrary to the preferences of the principal (agency 'shirking') (McCubbins and Schwartz 1984). To limit agency losses, principals can impose restrictions on agency autonomy in advance (*ex ante* controls) or by monitoring agency behaviour (*ex post* controls).

Pollack (2002) suggests that if the policy preferences of the principal are clear and relatively fixed, then delegation is primarily motivated by the need to reduce commitment problems. In this context, delegation will tend to be high and ex ante controls will be low to maximise the credibility of agent decisions. This is the case in the field of monetary policy where policy objectives are frequently defined in the form of quantitative inflation targets. Hence the trend over recent decades for delegating control of interest rates to independent central banks as a means to enable governments to signal their pre-commitment to maintaining low inflation (Grilli, Masciandaro and Tabellini 1991; Goodman 1992; Cukierman 1998, 2008; Gilardi 2007).

Applying this logic to prudential policy making is more contestable, however (Fernández-Albertos, 2015). On the one hand, Haldane (2013) argues that the case for delegation to operationally-independent regulators is as strong, and arguably stronger, for financial stability policy. This is because time inconsistency problems are even more acute: evidence suggests that financial cycles, compared to business cycles, are longer in duration, exhibit wider fluctuations, impose larger costs, and generate stronger constituencies of winners and losers (see Claessens et al. 2008). On the other hand, macroprudential policy objectives tend to be less quantifiable and more fluid than fixed monetary policy targets. This is because the countercyclical nature of prudential policy is time dependent, meaning that regulatory objectives must evolve with the rhythms of economic cycles (Baker 2013b: 419). Consequently, policy making is likely to be characterised by a high level of experimentation and learning for some time (Baker 2013b). Prudential policy making also involves making complex policy trade-offs with politically-sensitive and/or unknowable distributional implications which elected officials will be reluctant to 'lock in'. In this context, we would expect delegation of prudential powers to be driven less by the need to make fixed credible commitments, and more by other functional motives, such as the desire for efficient decision-making or blame shifting. This would lead us to expect that delegation to regulatory agencies will be lower, and ex ante controls to be higher, as political principals seek to retain the power to steer policy over time (Pollack 2002).

Furthermore, determining the institutional location of new prudential policy tools is also problematic. Combining monetary policy, macroprudential regulation and microprudential supervision in a single institution certainly brings benefits in terms of coordination. But it can also generate multiple conflicts of interest, such as the risk of moral hazard arising from bank supervisors having discretionary power to manage liquidity (Eijffinger and Masciandaro 2011). In short, delegation theory by itself does not provide a clear guide as to the optimal institutional design of prudential policy making.

Traditional functional accounts have two wider limitations which make them less useful for explaining patterns of post-crisis reform. First, delegation theories treat functional pressures as generated exogenously by the wider economic or political system (Adolph 2015: 6). Yet this presents a relatively static picture which tells us little about the dynamic and endogenous character of principal-agent relationships. Delegation is not simply a technocratic process, but a choice that is driven by a broader set of political objectives (Way 2000: 197). For example, studies suggest that the delegation of monetary policy can be an effective way of reconciling heterogeneous policy preferences and managing intra-party conflicts (Bernhard 1998; Bernhard and Leblang 2002; Gilardi 2007). Electoral incentives can also explain why left-wing parties may advocate central bank independence to signal their economic competence (Cukierman 1998; King 2005; Westrup 2007) or to strengthen their domestic policy autonomy (Dellepiane-Avellaneda 2013). Applying these ideas to post-crisis reforms, Lombardi and Moschella (2017) argue that the creation of new macroprudential authorities was driven by a 'logic of symbolic politics', designed to signal to the public that action was being taken.

Second, functional explanations tell us surprisingly little about the preferences and motives of regulatory agents, or how they may contest and (re-)shape delegation to suit their own bureaucratic interests (Carpenter 2001; Huber and Shipan 2002; Krause and Meier 2003). This form of agency loss concerns institutional choices about the design of delegation itself, not about the particular policy ends that delegation serves. Kapstein (1992: 266-67) argues that central banks are 'a group of bureaucrats...attempting to serve several conflicting public and private sector interests in an effort to maintain if not enhance their positional power'. Several studies show that central banks actively seek to shape the wider political and policy environment by exploiting their unique informational advantages, and cultivating expertise through wider regulatory networks (Brehm and Gates 1999; Masciandaro 2012; Adolph 2013). For example, Fernandez-Albertos (2015: 228) argues that many central banks deliberately advocated narrow policy mandates prior to the financial crisis so as to avoid having to make contentious policy trade-offs and thus minimise the risk of political interference.

A richer understanding of post-crisis reform must therefore account for wider political and bureaucratic motives for institutional change. Although functional explanations provide a powerful explanation of delegation based on the need to make credible commitments, the theory is far less well-developed with respect to the use of delegation for other reasons, notably blame shifting. Addressing this is essential in order to explain why the decision to grant new prudential powers to central banks has often been highly contentious and contested, resulting in institutional designs which appear suboptimal. To this end, we draw on broader theories of blame avoidance.

The politics of blame avoidance

Blame avoidance is a form of risk management that aims to minimise the attribution of responsibility for perceived avoidable harm or loss (Hood 2002; Hood 2011). It assumes that public officials, including both elected officials and unelected bureaucrats, exhibit strong negativity bias; that is, greater value is attached to avoiding potential losses than to attracting equivalent gains. Blame avoidance can be both reactive, by responding to current events in an effort to deflect blame and minimise damage to reputation, or anticipatory, which involves taking action to reduce the risk of attracting blame in the future (Hood 2011: 7). One of the most important strategies for blame avoidance is delegation. Principals can deflect responsibility by delegating decision making or policy implementation to quasi-independent agencies. In the event of policy failure, for instance, principals can shift the blame onto agencies and sidestep their own share of responsibility for past policy choices.

Theories of blame avoidance provide a richer account of delegation by explaining organisational designs that appear suboptimal (Hood 2011: 69). Functionalist accounts assume that decisions about delegation constitute a simple binary choice between retaining control or devolving responsibility. From a blame avoidance perspective, however, the nature of delegation can be highly uncertain and shrouded in ambiguity. This creates opportunities for principals to limit blame through the creative allocation of formal responsibility, competency, or jurisdiction amongst different organisational units. It therefore posits a more fine-grained spectrum from *hard* delegation at one end to *soft* and *fuzzy* delegation at the other (Hood 2011: 78). Soft delegation refers to a situation in which policy responsibilities are transferred to an autonomous agency, but the principal retains important levers of *ex ante* control or informal influence behind the scenes. For example, the principal may retain the capacity to reconfigure the mandate or composition of subservient agencies. In the case of fuzzy delegation, lines of responsibility may be deliberately blurred by creating disconnections amongst organisational units and from past structures (Hood 2011: 69). In this instance, the precise division of labour between principal and agent may be unclear or fluid. These weaker forms of delegation can serve as an important strategy of blame shifting, enabling principals to simultaneously deflect responsibility for policy failures while claiming credit for policy successes.

Theories of blame avoidance are also better placed to explain the contestability and changeability of delegation in several respects. First, delegation serves a wider symbolic purpose for principals that can generate conflict over institutional design. For instance, if particular agencies are closely associated with a political party in government, then opposition parties can assign blame for policy failure on both the agencies concerned and – by implication – the political principals that created them. In this sense, delegation not only provides the opportunity to deflect blame, but also to attribute blame to political opponents (see Sobol 2016). Furthermore, delegation provides an opportunity for principals to recast policy failure as institutional failure. In doing so, public officials can present themselves in a positive light by undertaking institutional reform, either by abolishing existing agencies or creating new ones, to demonstrate that they are in control of events (Carpenter 2001). In this way, *agency reconfiguration* not only serves as an instrument of blame avoidance, but can actually be reputation enhancing as it allows principals to take the credit for seizing the initiative.

Second, existing theories of blame avoidance say little about how agents respond to attempts to shift blame onto them. Yet the literature on bureaucratic reputation tells us that agencies are just as concerned with avoiding blame as principals (Carpenter and Krause 2012; Maor 2014; Gilad 2015). This is because reputation constitutes a valuable political resource which underpins an agency's autonomy. Avoiding blame and building a positive reputation enables bureaucracies to generate public support, gain greater responsibilities and powers, and protects them from political interference (Carpenter 2002: 491). This generates expectations about how agents respond to the delegation of new powers. Bureaucrats will push for full autonomy and hard delegation over powers that are potentially reputation enhancing, such as those that bestow high status, prestige or influence (Dunleavy 1991; Marsh *et al.* 2000; Gains and John 2010). Conversely, bureaucrats will try to limit their involvement in responsibilities which are likely to attract blame and thus potentially reputationally damaging, often by 'hiving off' these tasks to external organisations (Maor 2010, 2014). From a blame avoidance perspective, attempts by agents to reshape the scope and terms of delegation to limit blame and protect their reputation constitutes a special form of agency shirking: we label this *agency subversion*.

Finally, the theory also points to the limits of using delegation as a strategy of blame avoidance. Delegation is more likely to shield organisations from blame for policy failures where these are relatively self-contained and/or time limited (Hood 2012: 74-6). But if policy failures are likely to generate wider economic contagion, heightened political salience or prolonged negative publicity, organisations may be vulnerable to blame 'feedback'. In this situation, principals and/or agents may simply be unable to avoid becoming the target of mounting public anger for policy failure, regardless of formal lines of responsibility. In a context in which blame is likely to be attributed collectively, organisations have little incentive to try to avoid blame. Instead, the more prudent long-term strategy for managing reputational risk will be to maximise direct control and autonomy over key policy decisions.

Blame avoidance provides a theoretical basis for inferring the preferences and strategies of governments and regulators (our independent variables). These are used to explain the institutional design of central bank reform in the UK (the dependent variable). Process tracing is used to map and explain the sequence of events and key decisions leading to institutional change. An overview of the preferences of the two main political parties and the Bank of England is provided in Table 1.

Table 1. Overview of organisational preferences, and the final outcome, on post-crisis reform

	Labour party position	Conservative party position	Bank of England position	Outcome
Location of macroprudential powers	Financial Services Authority	Bank of England	Bank of England	Bank of England
Structures for macroprudential policy making	Council for Financial Stability (Chair: Chancellor)	Financial Policy Committee (Chair: Chancellor)	Financial Policy Committee (Chair: Governor)	Financial Policy Committee (Chair: Governor)
Location of microprudential supervision	Financial Services Authority	Bank (core division)	Separate or subordinate agency	Bank (PRA subsidiary)

The following section examines the preferences of the main political parties in the run up to the 2010 general election to understand their motives for central bank reform. We then turn our attention to explaining the precise terms of delegation as negotiated by the new Coalition Government (the principal) and the Bank of England (the agent). The final section concludes.

Blame avoidance and agency reconfiguration

The UK's preferences on banking regulation underwent a dramatic shift during 2007-2010, rooted in the government's experience of the financial crisis. Historically the UK had been a cheerleader for 'light touch' financial regulation (Quaglia 2008; Mügge 2011). But the fiscal burden of bailing out two of the UK's largest banks sent shockwaves through the political establishment. There was broad cross-party consensus that the existing banking regulatory system was fundamentally broken. In the blame game that followed, much of the immediate anger for the failures of supervision were directed at the Financial Services Authority (FSA)

(Treasury Committee 2009). But the Bank of England also became the target of mounting criticism for its failure to take wider responsibility for the health of the banking system:

> 'There was a lot of criticism about the Bank of England's withdrawal from its leadership role in the City…Mervyn was very hostile to that. He was determined that the new Bank [after 1997] should not be seen to have a special interest in the health of the banks…There were definitely worries in the Treasury that the tripartite system wasn't working as smoothly as it should…because of attitude of the Governor.'[2]

Officials and industry leaders acknowledged the central bank's share of the responsibility, arguing that it had 'fumbled' the management of the bank failures because it 'couldn't decide what to do'.[3] But there was also puzzlement that, with hindsight, it had avoided much of the blame:

> 'Politically, this had been a disaster…The Treasury wanted the Bank to play a more forward role in managing the [Northern Rock] situation, but the Bank refused to do that…[They] thought that we were endangering UK financial markets and that we were not doing our job. But Mervyn was determined and we sort of limped through…It's a bit of a miracle the Bank kept its credibility, but it did…It was the politicians who took the blame, and central banks emerged largely untouched.'[4]

To explain how the Bank emerged with its reputation largely intact, it is necessary to analyse how political principals responded to the banking crisis by deflecting blame down to regulatory agencies.

The incumbent Labour government's instinctive response was to defend the tripartite system it had created in 1997. It sought to deflect blame away from the FSA and kill off any attempt to have its powers reduced or for it to be scrapped altogether. The Chancellor, Alistair Darling, asked the new Chair of the FSA, Lord Turner, to undertake a review of the UK's regulatory framework (Turner 2009). The review recommended that financial regulators be granted enhanced macroprudential powers which should be managed collaboratively by both the Bank and the FSA. In response, the Labour government proposed that the existing tripartite system should be strengthened with the creation of a new Council for Financial Stability, chaired by the Chancellor. This would constitute a powerful ex ante control mechanism through which the government would steer macroprudential policy making. Moreover, it rushed through legislation giving the FSA an explicit financial stability objective and a range of new macroprudential regulatory powers (HM Government 2010b).

By contrast, the Conservative opposition called for the abolition of the FSA and for the bulk of its regulatory and supervisory powers to be transferred to the Bank of England. They blamed the FSA for the regulatory mistakes which contributed to the crisis, arguing that empowering the Bank would lead to more efficient decision-making as it would be less prone to industry capture (Conservative Party 2009: 19-20). But from the perspective of senior officials, this was viewed as an attempt to recast the banking crisis as institutional failure to deflect criticism of their own pre-crisis role:

> 'The Tories couldn't credibly say we had been too light-touch on regulation, because they had argued that we over-regulated the City. So they quite quickly and intelligently launched on the idea that we had gotten the structure of regulation wrong…As a government we resisted the debate over regulatory structure as long as possible.'[5]

The Conservatives' position was described as 'intellectually lazy' as it was not based on serious 'academic analysis'; instead, it was interpreted as 'motivated by the politics of blame', enabling them to apportion culpability for the crisis on the incumbent Labour government:[6]

> 'The Tory party wanted to pin this on Gordon Brown…If you're George Osborne you need to have a snappy answer to why won't it happen again, and who is to blame…It was a political attack.'[7]

In accordance with the theory, agency reconfiguration was used as a strategy of blame avoidance at the height of the banking crisis. Key elected officials sought to recast the crisis as an institutional failure in order to deflect responsibility for their own pre-crisis policy choices. Moreover, the two main parties sought to deflect blame onto their political opponents. This led them to hold diametrically opposed views about which institutions were at fault, and thus to put forward competing proposals for reform.

The Bank of England's ability to avoid blame rested in large part on the outcome of a wider political contest for power. Nonetheless, in the run up to the 2010 General Election, it was proactive in seeking to deflect blame for the crisis and to defend its own reputation. Its initial response to the possibility of institutional reform highlighted its deep-rooted risk aversion. During 2007 and early 2008, the Bank's overriding priority was to protect its narrow monetary policy mandate and credibility on price stability. The Governor in particular was 'nervous' about plans to expand its prudential regulatory role:[8]

> ‘Mervyn was less keen, because he saw the danger of this getting us back into being infected by the shenanigans in the financial sector, and he wanted us to be a monetary policy body above all else…There was a group of people within the Bank, including several of the external MPC members, that thought it was a government function not a Bank function.’[9]

Yet from late 2008 onwards, the Bank underwent a sudden change of heart. We argue that the politics of blame avoidance are key to understanding this preference shift. As the banking crisis worsened, the Bank came to recognise the limits of delegation as a strategy for avoiding future reputational damage. In particular, the Governor was persuaded that the central bank could no longer be shielded from criticism of the banking system:

> ‘Ultimately, if we are on the hook then we take some of the reputational hit from things going sour. Then the worst position to be in is responsibility without power…This was not about we must have power, we must have responsibility. In some ways, we came at it from the opposite angle. The conclusion was that we need some protection.’[10]

> ‘Around the time of Northern Rock, [King] suddenly realised that his face was on quite a lot of this stuff anyway. He’d made a big misjudgement…What you then try to do is to make sure that you are in control of a number of levers but also try and de-risk the job.’[11]

An added incentive was provided by inter-agency rivalry. The Labour government’s decision to legislate to grant the FSA new macroprudential responsibilities was viewed as a direct threat to the status of the Bank.[12] In response, senior Bank officials began to lobby against the government’s plans: ‘[King] didn’t want anyone else doing macroprudential. The Bank was pushing for that.'[13] To defend its reputation, it also engaged in blame avoidance by deflecting responsibility for the banking crisis:

> 'It's not as if we had been completely blind sided by the crisis in not having seen the build-up of risks. We set them out as candidly and clearly as anyone before the crisis in the financial stability reports…People had taken not a blind bit of notice. So words by themselves clearly hadn't done the trick, but words was all we had. All the regulatory tools were in the hands of the FSA…So nothing was done.'[14]

> '[King] could see which way the election was going and tugged that way…There was a lot of self-justification going on. He gave a lot of speeches aimed at trying to guard his place in history by shifting blame onto politicians and others who wouldn't let him do what he wanted to do.'[15]

The Bank arguably 'went further than it should' in trying to shape the pre-election political agenda.[16] For example, the Governor openly criticised Labour's proposals in the 2009 Mansion House speech, complaining that it would be unable to discharge its statutory responsibility for maintaining financial stability if all it could do was 'issue sermons and organise burials' (King 2009: 9). Furthermore, following the Conservatives' strong performance in the 2009 European Parliament elections, senior Bank officials held several meetings with the Shadow Treasury team to discuss how the central bank's role could be overhauled following the election.[17] These talks fed into the publication of the Conservatives' own proposals, based on the recommendations of a report published by Sir James Sassoon, which pledged to abolish the FSA and transfer most of its responsibilities to the Bank of England (Conservative Party 2009:

14-16). As a senior official confirmed, the Conservative's 'comprehensive plan' for reform could not have been developed 'without Bank of England involvement prior to the election.'[18]

The Bank's actions suggest that concerns about blame avoidance were paramount in shaping its position on agency reconfiguration. In particular, the Bank was determined to defend its reputation during the crisis by deflecting the blame onto others. But it also highlights the limits of using delegation as a strategy of blame avoidance. Given the risk that blame for future banking crises would be attributed to the central bank anyway, the Bank calculated that the best strategy to protect its reputation was to claim the new macroprudential powers for itself. Ultimately, these longer-term reputational concerns were sufficient to overcome its instinctive risk aversion to taking on an expanded policy mandate.

Blame avoidance and agency subversion

The UK general election which took place in May 2010 heralded a change of government, leading to the formation of a new Conservative-Liberal Democrat Coalition. The outcome did not initially augur well for the prospect of reform because the two parties had heterogeneous preferences on the structure of delegation. While the Conservatives had pledged to scrap the FSA and transfer its powers to the Bank, the Liberal Democrats had broadly supported the Labour government's efforts to strengthen the existing tripartite system.

A political deal was possible, however, because the junior coalition party's main priority was securing a wider commitment to structural reform of the banking system; that is, the structural separation of retail and investment banking (Liberal Democrats 2010: 16-17). The Coalition

Agreement linked the issue of central bank reform and structural reform by making two commitments: first, reform of the tripartite supervisory system by abolishing the FSA and transferring most of its responsibilities to the Bank of England; and second, the establishment of an independent commission to investigate the viability of structural reform (HM Government 2010b: 9). This act of political expediency paved the way for the delegation of significant new powers to the central bank, the precise institutional design of which was negotiated by HM Treasury (as the principal) and the Bank of England (as agent) during 2010-2011.[19] The following section details the preferences of the two actors, and explains the outcome of the negotiations with respect to both macroprudential regulation and microprudential supervision.[20]

1. Macroprudential regulation – hard delegation

As the negotiations progressed, important differences emerged between the Treasury and Bank over the terms of delegation of new prudential powers. Although the central bank remained fully committed to the concept of macroprudential regulation, it harboured concerns about precisely what form this would take. Above all, it feared that the new powers could compromise its monetary policy credibility and operational independence if the government sought to retain the ability to steer macroprudential policy, which it might conceivably try to manipulate for electoral reasons. The Bank's fears were confirmed when the government proposed the creation of a new Financial Policy Committee (FPC) to be chaired by the Chancellor. This was designed to rein in the power of the Governor, while ensuring that the Chancellor would have the final word on prudential matters:

‘If it were left to the Treasury, we would have left the process as it was and created a Council of Financial Stability with the Chancellor chairing it for greater accountability. Because it is always public money on the line.’[21]

The Bank leadership viewed this as a direct reputational risk. In blame avoidance terms, the government’s proposal amounted to a form of ‘soft’ delegation which would create a powerful ex ante control mechanism over the central bank. In practice, this would allow the government to shift responsibility – and thus blame – for macroprudential regulation onto the Bank, whilst retaining the power to determine the policy objectives. Recognising that the Bank could no longer insulate itself from blame for future banking crises, it was determined to maximise its control over macroprudential policy making. It therefore proposed the ‘hard’ delegation of macroprudential powers based on ex post accountability; this meant that the new FPC should be modelled explicitly on the Monetary Policy Committee (MPC), with the Bank Governor as Chair.

To make its case, the Bank appealed to functionalist arguments about credibility. It suggested that only central banks had the necessary expertise to use macroprudential policy tools responsibly, and warned against the tendency of elected politicians and other ‘non-experts’ to interfere (Treasury Committee 2011: 126). From the government’s perspective, the Bank’s most important source of power was its ability to signal that its political independence had been compromised:

‘If Mervyn suddenly started saying this is no longer an independent central bank, the Treasury are now telling me what to do, then that would have been very bad for the markets.

So the Bank had an ace to play, and everyone knew that. There was a limit to how much we could push him.'[22]

Ultimately, the new and relatively inexperienced Chancellor did not have the stomach for a public battle with the long-serving Governor:

'Overall, the Bank got the framework it wanted more often than not. There was a strange relationship between Osborne and King. Osborne did not want to risk an argument with the Bank of England. So whenever the Bank really wanted something in the negotiation, it would escalate it to Governor – Chancellor level and get its way.'[23]

The Bank was able to shift the terms of delegation decisively in its favour. The final design of the FPC therefore emulates the MPC with minimal ex ante controls. Additional safeguards were also put in place to ensure that the demands of financial stability would not interfere with the operation of monetary policy.[24]

'We did have a model, it was called the MPC model, and it was trialled and tested and trusted…We provided advice on them, so it's no surprise that the FPC and the PRA board are very roughly modelled on the MPC…At root it's the same model: ex ante mandate, ex post accountability.'[25]

The institutional design established for macroprudential regulation owes a great deal to the politics of blame avoidance. The government was keen to limit delegation to the central bank by retaining important ex ante control mechanisms. In theory, this soft delegation would potentially allow it to shift blame to the Bank for policy failures, but to take credit for policy successes. Recognising this, the central bank engaged in a strategy of agency subversion by using its full bureaucratic leverage to reshape the government's plans. This enabled it to secure a harder form of delegation which maximised its control over new policy tools and offered greater protection of its reputation.

2. Microprudential supervision – fuzzy delegation

At the level of microprudential supervision, the Coalition upheld the main recommendations of the Sassoon Report. It was critical of the Bank's narrow mandate, arguing that control of interest rates should be closely coordinated with the supervision of individual bank balance sheets to strengthen regulators' capacity to respond flexibly to crises (Conservative Party 2009). Centralising monetary, macroprudential and microprudential functions would concentrate market and institutional insight into one authority and create a single point of accountability. The government therefore proposed that the FSA should be abolished and responsibility for supervising individual firms transferred to a new Financial Regulation Division in the Bank (Conservative Party 2009). As a result, microprudential supervision would become a core function of the central bank, fully integrated into its central governance structures and with direct responsibility transferred to the Governor. The FSA's remaining function, for conduct regulation, would be housed in a separate agency.

The Bank of England had serious reservations about the reputational risk involved in managing day-to-day supervision. First, it was concerned that conflicts of interest could damage the credibility of the Bank's monetary and macroprudential role. In particular, it feared coming under external pressure from government and industry to use its new discretionary powers on capital to help struggling institutions. Second, it recognised that firm-level supervision is highly imperfect and prone to mistakes. The Bank had been scarred by the collapse of Barings and BCCI in the early 1990s, and was acutely aware that supervisors would ultimately be blamed for industry scandals, poor standards and bank failures. These concerns were articulated by both senior Bank and Treasury officials:

> ‘There was considerable nervousness about assuming further regulatory responsibility. To argue that we were desperately keen to get back what we had lost in 1997/98 is just not true. You can either lose or draw, but you can never win – and we were acutely aware of that. That was the rationale for moving across prudential regulation [to the FSA] in the first place…[Supervision] could be anywhere. There’s no intrinsic reason it has to be us.’[26]

> ‘The Bank always felt that the monetary policy element should avoid reputational damage that comes with supervision. They were not happy about the micro-economic supervision they inherited…[King] developed very strong views on the micro-prudential side. He definitely wanted the power on intervention, but none of the responsibility for it. The Bank wanted to be able to direct supervisors, but not supervise...They didn’t want anything to do with it. They don’t understand it and pushed back very hard.’[27]

The Bank was determined to insulate itself against future reputational damage. Its ‘Plan A’ was to take the lead for macroprudential policy, ‘but not necessarily to take over the Prudential Regulatory Authority – i.e. the actual supervision of major financial institutions’.[28] However, it also recognised that the government had a powerful political mandate for reform and that the abolition of the FSA was a *fait accompli* (Conaghan 2012: 254). Rather than resist the changes, the Bank’s leadership therefore pursued agency subversion aimed at remoulding the terms of delegation into something it could live with. Its Plan B was to keep microprudential issues as far away from the core of the Bank as possible; ideally, the supervision of firms should be conducted by a separate entity, but one which the central bank would have the power to direct on the basis of its financial stability mandate.

The Bank proved highly effective at reshaping the Coalition's plans. As a Bank official argued, 'We were influential in that we got our analytical arguments straight early on and set them out very clearly. So in terms of the overall architecture of the Bill we had an important shaping role to play.'[29] This was confirmed by a Treasury official: 'The Bank was heavily involved in the details of the Financial Services Bill. Anything that it felt undermined its independence it lobbied very hard on.'[30] The institutional design which emerged created two new bodies: the Prudential Regulation Authority (PRA), responsible for the prudential regulation and supervision of financial institutions; and the Financial Conduct Authority (FCA), which regulates financial products and consumer services. This structure differs from that originally envisaged in three key respects.

First, the Bank successfully resisted the government's plans to centralise supervision 'over concerns that it could not be independent if it became part of the core Bank'.[31] Instead, it was agreed that these functions would be housed in a separate subsidiary – the PRA – with its own legal personality and governance structure. This ensured that the new body would have full operational independence for day-to-day supervision and responsibility for firm-specific decisions (HM Treasury 2010: 29). From the Bank's perspective, this structure was essential in order to create a firewall around its core monetary and macroprudential activities.

Second, over time the division of labour between the PRA and FCA has been deliberately blurred. Contrary to the government's original intentions, firm-level supervision is effectively split between the two agencies. Their formal role is deliberately ambiguous: while the PRA has prudential responsibility for 'all deposit takers, insurers and significant investment firms', the FCA provides prudential supervision for any institutions 'not regulated by the PRA' (Bank of England 2013: 1). In practice, this has enabled the central bank to limit its direct involvement in supervision by 'cherry picking' the largest banks to oversee, while making clear that it had 'absolutely no interest' in regulating any others.[32] As a result, the PRA directly supervises only those firms that pose a potential macroprudential risk, while supervision of the majority of firms is delegated to the FCA, making it the largest prudential supervisor in Europe (FCA 2016).

Finally, the Bank also sought to enshrine the subordinate status of the two supervisory agencies by designing important ex ante control mechanisms. Hence both the PRA and FCA are required to comply with the Bank's broad recommendations on financial stability or publish a justification of why they disagree (Bank of England 2013). King also requested a range of 'backstop veto powers' over the PRA and FCA to ensure that their decisions would not conflict with the Bank's new macroprudential objectives (Treasury Committee 2012: 29).

From the government's perspective, what emerged was far from ideal because it has created a more complicated structure, and marks less of a symbolic break with the past, than the Chancellor had intended:

> '[King] was interested in having a split role, and you can see that in the design of the Bank post-reform. There are too many committees – an MPC, FPC and PRA – all of which he chairs. Where the hell did that come from?...We've still got three organisations and they all need to cooperate. But the presentation of being able to abolish a body is much more

powerful than just creating another coordinating committee…From Osborne's point of view, to say we are creating a new committee is much less clear cut than saying we are abolishing Brown's FSA and putting it back in the Bank…There is now the FCA, but which is in the old FSA building and is staffed with FSA employees. The people don't get abolished, and nor do the offices.'[33]

In important respects, the new structures contradicted the government's own logic for scrapping the FSA. For example, locating microprudential supervision in an operational subsidiary makes coordination with the Bank more difficult to achieve by generating new sources of conflict:

'You knew that the FSA was the single regulatory body…so there was clarity about it. What you have now is, with the FCA and PRA, two regulators that are working to a slightly different agenda that actually conflicts.'[34]

In addition, the blurred division of labour between the PRA and FCA leaves sectors like insurance 'stuck slightly uneasily' between different institutions, while the FCA's supervisory role contradicts the original objective of separating supervision from conduct regulation.[35]

The Bank's actions with respect to microprudential issues reflect a concern, above all else, to protect itself from future reputational damage. In response to having supervisory powers foisted upon it, the central bank used 'fuzzy' delegation to blur responsibility by shifting day-to-day oversight of individual firms down to separate and subordinate agencies. This enabled the Bank to insulate its core monetary and macroprudential functions by potentially deflecting blame for future supervisory failures. Yet this has produced an institutional design that is suboptimal in several important respects. We argue that this points to blame avoidance, rather than efficiency gains, as being the main driver of the reform process.[36]

Conclusion

The ambition of this paper was to explain the strengthening of the UK central bank with new prudential powers. The main puzzle was that the institutional design which eventually emerged not only diverged significantly from the government's original plans, but that it was also suboptimal in several important respects. We argue that the reforms cannot be explained on the basis of credible commitments or decision-making efficiency. Instead, we argue that the changes owe far more to the politics of blame avoidance and managing reputational risk. Theories of blame avoidance provide empirical expectations about the behaviour of principals and agents in a context of policy failure. This enables us to refine existing ideational and functional explanations, and to provide a richer account of the contested and contingent character of post-crisis reform. The article makes two main claims.

First, political principals used *agency reconfiguration* as a strategy of blame avoidance at the height of the banking crisis. Key elected officials sought to recast the crisis as an institutional failure in order to deflect responsibility for their own pre-crisis policy choices. Moreover, the two main parties sought to deflect blame onto their political opponents. This led them to hold diametrically opposed views about which institutions were at fault, and thus to put forward competing proposals for reform. Second, bureaucratic agents used *agency subversion* to protect or defend their reputation. This involved reshaping the terms of delegation in such a way as to deflect or manage blame for future policy failure.

Importantly, our analysis highlighted both the importance and limits of delegation as a strategy of blame avoidance. With respect to microprudential supervision, the Bank of England was instinctively risk averse about taking on direct responsibility for individual firm-level oversight. In response, it calculated that blame for future bank failures could be minimised by blurring responsibility through fuzzy delegation. To protect its core monetary and macroprudential functions, it therefore sought to shift responsibility for day-to-day supervision down to separate and subordinate agencies. With respect to macroprudential regulation, the Bank was similarly hesitant about the prospect of an expanded policy mandate. By contrast, however, it also recognised that it ultimately could not avoid future blame for failures in the banking system. As a result, the Bank calculated that the most prudent strategy to minimise long-term reputational risk was to push for full control over new macroprudential tools. It therefore sought to resist government efforts to impose a form of soft delegation, and instead lobbied successfully for a hard delegation model of macroprudential policy-making that maximised its own control and policy discretion.

The article contributes to the broader political economy literature on central banks in two ways. First, the concept of agency subversion as a strategy of blame avoidance sheds new light on the influence of central banks within government. In particular, our analysis highlights three sources of bureaucratic power which regulatory agencies can potentially wield over political principals: the ability to signal to the market that their political independence, and thus credibility, has been compromised (we label this 'market power'); the capacity to engage in private lobbying and make public pronouncements to pressure ministers ('instrumental power'); and the ability to exploit institutional permanence, and the status and experience of senior officials, over newly-elected political principals ('political power'). In the case of the UK, the Bank of England was able to leverage these bureaucratic powers to reshape delegation such that the final outcome was significantly at odds with the original intention of the newly-elected government.

Second, the study highlights the need for a broader interpretation of functional motives in theorising central bank reform. Although blame shifting has been identified as a potential driver of delegation (Pollack 2002), most functionalist accounts tend to assume 'rational' motives based on credible commitments or decision-making efficiency. Yet there is a disconnection with those empirical studies which show that central bank reform often leads to counter-intuitive, or even *dys*functional, outcomes. These are instead typically attributed to partisan or political incentives (for example, Bernhard 1998; Bernhard and Leblang 2002; Gilardi 2007). We argue that theories of blame avoidance are well placed to bridge this gap. By inferring that principals and agents are also concerned with reputation, we can explain how functional motives may, paradoxically, lead to suboptimal institutional outcomes. In the UK case, this can even include forms of delegation which are potentially detrimental to both credibility (as in the case of the government's original design for the Financial Policy Committee) or efficiency (for example, the coordination problems between the PRA and FCA). The blame avoidance approach we develop here is therefore intended as a guide to future comparative research which can potentially provide a better understanding of variation in post-crisis reform.

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[1] The ECB distinguishes between three main supervisory models: (i) sectoral model: each sector (banking, securities and insurance) is supervised by one authority; (ii) 'twin peaks' model: responsibilities are allocated on the basis of the supervisory objectives, with prudential supervision and conduct of business regulation attributed to two different authorities; and (iii) single authority model: all the supervisory functions are allocated to a single authority, which covers both prudential supervision and investor protection (ECB 2010).
[2] Interview with former senior Bank of England official (January 2015).
[3] Interview with financial industry lobbyist, UK bank (December 2014).
[4] Interview with former senior Bank of England official (January 2015).
[5] Interview with former No.10 senior official (November 2014).
[6] Interview with HM Treasury official (January 2015) and former HM Treasury Special Advisor (November 2015).
[7] Interview with former senior Bank of England official (January 2015).
[8] Interview with senior Bank of England official (November 2013).
[9] Interview with former senior Bank of England official (January 2015).
[10] Interview with senior Bank of England official (November 2013).
[11] Interview with former Bank of England official / financial industry executive (December 2013).
[12] Interview with former No.10 senior official (November 2014). Puzzlingly, the FSA Chairman, Adair Turner, remained relatively open-minded about their location. Our interviews suggest that this was because 'he might have had half a chance' at being given a senior role in the Bank in the near future. Moreover, in the run up to the election, the FSA received assurances that the changes would not necessarily be implemented: 'They were given

a strong indication…that the [Conservatives] wouldn't go ahead with [the Sassoon Report]…It came as a bit of a shock to them when the new government decided it was going to go ahead.' (Interview with senior HM Treasury official, November 2014).

[13] Interview with former senior Bank of England official (January 2015).

[14] Interview with senior Bank of England official (November 2013).

[15] Interview with former No.10 senior official (November 2014).

[16] Interview with former No.10 senior official (November 2014).

[17] Interview with senior HM Treasury official (June 2015). See also Conaghan (2012: 239-41).

[18] Interview with former HM Treasury Special Advisor (November 2015).

[19] The Treasury-Bank negotiations were overseen by a committee composed of the Chancellor of the Exchequer (George Osborne), the Treasury Permanent Secretary (Nick Macpherson) and Second Permanent Secretary (Tom Scholar), the Bank Governor (Mervyn King) and Deputy Governor (Paul Tucker), the FSA Chairman (Adair Turner) and Chief Executive (Hector Sants), which met every few months. The day-to-day negotiations were handled by a working group of senior officials. (Interview with senior HM Treasury official, November 2014).

[20] We find no evidence that the financial industry had strongly-held preferences on central bank reform. There was little lobbying against the proposed changes, not least because many banks were quietly supportive: 'The City banks always preferred dealing with the Bank as opposed to the FSA. They wanted a powerful Bank who speaks for them. Now though you have a powerful Bank that also kicks them about. But nonetheless I think they favoured this move' (Interview with former senior Bank of England official, January 2015). From industry's perspective, how the new powers would be used was a more pressing concern than where they were to be located: 'I think most banks realised that regulation was going to get tightened, irrespective of the structure. So I don't remember them being massively unhappy with this' (Interview with former No.10 senior official, November 2014).

[21] Interview with senior HM Treasury official (June 2015).

[22] Interview with former No.10 senior official (November 2014).

[23] Interview with senior HM Treasury official (June 2015).

[24] For example, it was stipulated that the FPC should receive all its briefings from the MPC, ensuring that its decisions are made on the basis of information received from the latter (Interview with member of the Financial Policy Committee, April 2016).

[25] Interview with senior Bank of England official (November 2013).

[26] Interview with senior Bank of England official (November 2013).

[27] Interview with senior HM Treasury official (June 2015).

[28] Interview with former senior Bank of England official (January 2015).

[29] Interview with senior Bank of England official (November 2013).

[30] Interview with HM Treasury official (January 2015).

[31] Interview with senior FSA/PRA official (November 2015).

[32] Interview with senior FSA/PRA official (November 2015).

[33] Interview with former senior Bank of England official (January 2015).

[34] Interview with financial industry lobbyist, UK bank (December 2014).

[35] Interview with former senior Bank of England official (January 2015).

[36] Further evidence for this comes from the fact that under Governor Mark Carney, these institutional structures have undergone further revision. In particular, the Bank of England Act (2016) abolishes the PRA's status as a subsidiary with its own board. This is designed to streamline decision making, and strengthen governance and accountability, as part of Governor Mark Carney's 'One Bank' strategy (Reuters 2015). The changes, coming just two years after the original reforms were agreed, points to the suboptimality of the institutional compromise insisted upon by King. Notably, however, the blurred division of labour between the PRA and FCA for microprudential supervision remains in place.